

Outsourcing Contract Analysis

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OUTSOURCING CONTRACT ANALYSIS

For: BEVERLY ENTERPRISES, INC.

I. Introduction

Beverly Enterprises, Inc., the nations' largest provider of Nursing Home Health Care, is considering outsourcing the majority of its Information Systems (MIS) activities. Proposals have been received from Systematics and ISSC (IBM) for provision of these services and a comprehensive plan has been received from the internal MIS function for comparative purposes. Ernst and Young has been retained to assist Beverly in providing information to the prospective outsourcing vendors, to assist in analyzing the proposals, and to assist in developing the contract.

INPUT has been retained by Beverly to review the process by which the proposals were obtained, to further assure consistency of optional proposals, to review proposals and contracts for completeness and consistency with industry practice and to provide recommendations for improvement.

II. Motivation for Outsourcing

A. Motivations

Beverly Enterprises has developed an interest in outsourcing for the following reasons:

- Beverly is dissatisfied with the performance of its Application Development activities. The perception is that projects are slow to be completed, developed at an excessive cost, are more complex and detailed than required and are not well disciplined. Further, Application Maintenance backlogs are excessive and are impacting performance of the corporation. The belief is that these opinions are widely held throughout the enterprise. It is felt that having these services provided by an outside organization at incremental cost, will result in more sensitivity to cost and emphasis on what is needed not what would be nice to have.
- Beverly's mainframe computer system is running at full capacity and an upgrade is contemplated. Entering an outsourcing arrangement at this time would obviate the need for a processor upgrade.
- Beverly has a desire to reduce its presence in Virginia Beach and relocate much of the function to Fort Smith, Arkansas. Outsourcing the MIS function would significantly simplify moving and would greatly reduce corresponding risk.

- The proposals being contemplated would provide for much of the expense to be "variable". That is Beverly would have the capability to increase or decrease expense based on its need. It is felt that this capability would motivate the organization to spend its resources wisely and use what is needed.
- It is hoped, and believed, that outsourcing of the MIS function will result in overall cost reduction.

B. Observations and Comments

1. Mainframe Operations

There seems to be little concern over outsourcing the mainframe operations and programming.

- These activities are viewed as utility rather than strategic, are mature, and should be subject to economy of scale.
- The physical location of these service activities is of little consequence and outsourcing would materially simplify relocation.

The head of the MIS function did express concern and disagreement with respect to outsourcing responsibility for the Distributed Applications (System 36 and AS400). The feeling was that:

- These activities are strategic to the enterprise.
- The prospective outsourcing vendor (Systematics) had little to offer in this area with respect to applications.
- There is no economy of scale and the benefit all accrued to the outsourcing vendor.

INPUT believes that these views do not take into account some of the potential benefits of working with an outsourcing vendor; e.g.

- The opportunity to apply advanced development technologies currently utilized by most outsourcing vendors.
- The potential availability of superior business analysis techniques and methodologies.
- Enhanced sensitivity to cost.

2. Applications Development

With respect to the application development issue, INPUT sees several possible problems with the current environment.

- MIS is highly centralized and may not be as in touch with the business as it should be.
- There is no charge back system and there does not appear to be consistent cost benefit analysis on projects.
- User departments do not appear to take responsibility for systems cost and compete for what share of the development activity they can get.
- Tools, methodologies and techniques currently used for development are below industry standards.

Outsourcing to a firm which has a significant presence in applications development is one means of solving the current dilemma. It may not be the best long term solution, but it should provide immediate benefits and is the easiest solution to implement.

II. Chronology

The following summarizes INPUT's understanding of the events leading up to the present situation based on on-site interviews and telephone conversations. The information was gathered for the purposes of:

- Providing supplemental data to be utilized in assessing the competitive proposals of the two contending outsourcing vendors.
- Gathering background information to assist INPUT in developing an opinion as to whether the each vendor has been given the same opportunity to bid on the contract.

A. History

- Interest in outsourcing evolved from discussions between William McBride, VP and Comptroller of Beverly and Systematics involving possible development of a new General Ledger package by Systematics for Beverly Enterprises. The need to go outside for this package arose from the belief that the internal MIS Department was too busy to implement a new system for the Finance Department. As a result of the discussions, Systematics submitted to Beverly a *Preliminary Proposal for Facilities Management* dated January 8, 1992.

- Feeling the need for a competitive bid, Beverly requested IBM to develop a proposal and received from IBM a proposal dated April 13, 1992. Beverly Enterprises also held discussions with Perot Systems and Affiliated Computer Services (ACS) but did not request a proposal from either firm.
- Ernst and Young was engaged to assist Beverly in determining outsourcing requirements, evaluating proposals, and developing a contract. After analysis of the initial proposals, Mr. Richard Wilcox of Ernst and Young submitted identical letters to IBM and Systematics on Beverly's behalf, dated April 20, 1992, requesting modification of their proposals to provide the specific services which Beverly wished addressed. IBM responded with their proposal on April 24, 1992 and submitted an unsolicited additional modification on June 16, 1992. Systematics' response was dated April 22, 1992. A further letter was sent Systematics on May 1, 1992, requesting clarification of certain items and a response was received May 5, 1992.
- The internal MIS department was requested to prepare Seven Year Cost Projections to encompass the same services requested of the outsourcing vendors. This should permit a comparison of the external versus internal solutions. A projection was received May 7 and a revised projection on June 3, 1992.
- On May 13, 1992, Systematics transferred to Beverly a Contract Draft. To provide assistance in contract development, Beverly engaged Messrs. Michael A. Epstein and Selwyn B. Goldberg of the Law Firm Weil, Gotshcal & Manges, who are known for their experience in outsourcing contract development. Comments on the draft contract were received from these gentlemen dated May 21, 1992.
- INPUT was engaged the week of June 15th and completed a preliminary analysis on June 25th. A preliminary draft of this report, dated June 28, 1992 was submitted to Bill McBride on June 29th. Since the preliminary analysis identified some significant discrepancies between the proposals, the report suggested that additional discussions take place on specific points with each of the vendors in order to provide more refined data for the final analysis.

Since that time, both INPUT and Beverly personnel have dicussed the key issues with the vendors, obtained clarification on some points, and negotiated changes. INPUT believes that enough of the issues have been resolved to consider what follows as a comparison of largely comparable alternatives.

B. Observations and Comment

The process used by Beverly to obtain proposals is a reasonable one. Initially, giving vendors freedom to identify those areas which they wish to support is helpful to a client in determining the types of services which can be obtained, the approach, cost, and consistency. Having several proposals helps the client determine the scope and services which he wishes to entertain. The client is then in a position to identify to the potential vendors the specifics which he wish them to consider and is then able to make direct comparisons on the bids.

Having a reliable in-house estimate of cost for providing comparable service is a requirement in assessing the benefit and risk of vendors' proposed solutions. In Beverly's case, considering only two external solutions, provides no guarantee that they are getting the "best" solution, but comparing two external proposals with the in-house solution can provide comfort that they are getting a "good" solution.

Assuming relatively comparable costs one of the most important considerations in selecting an outsourcing vendor is choosing a firm in which the company has confidence. "Cultural fit", and "trust" are important. It is a long term, close relationship with high interdependence. It involves the transfer of a number of employees from the client to the vendor who need feel comfortable with the relationship for it to be successful for either party. It must be perceived as a "win-win-win" for the vendor, client and employee. However, this should not be construed to imply that a good tight contract is not a requirement. A good contract will help assure that problems and differences will be minimized.

III. Proposal Analysis

The first set of detailed proposals designed to address a common set of requirements came as a result of a letter sent to IBM and Systematics by Mr. Richard Wilcox (E&Y) dated April 20, 1992. The letter (described earlier in the chronology) enumerated the types of services to be covered in the agreement and further stated that the services should be costed to provide substantial flexibility to a Steering Committee in determining on going levels of utilization.

Responses were received from the vendors addressing the desired scope of services. In addition, an in-house "base case" was developed to provide a benchmark against which proposals could be evaluated. The three solutions all appear to address Beverly's requirements and could prove workable. Unfortunately, the request for proposal was sufficiently vague that the resulting responses cannot be compared in a straightforward manner.

In the discussion which follows INPUT will present its analysis of the key components of each proposal and the significant differences between them. In the next section a financial analysis is presented which attempts to put the three solutions on a comparable footing.

A. Systematics

The Systematics proposal is the most detailed and clearly reflects time and effort invested in understanding Beverly's business and interests.

1. Key Proposal Elements

- *Coverage* - Systematic's proposes that Beverly Enterprises retain responsibility for Distribution (Print Operations), SAR Administration, End User Help Desk services, and the Regional DP Consultants. Collectively, these activities are 40-46 persons. Different sources of data reflect different complement so exact comparison is impossible. However, the differences are minor in the aggregate.
- *Personnel* - Systematics proposes that it hire 135 of Beverly's 175-181 MIS personnel and relocate the data center activity to Little Rock, Arkansas This is the equivalent of about 35 people.

Systematic's base proposal provides for shrinking the staff to 49 persons to provide support to applications and an additional 6 people to support communications (2-voice, 2-data, and 2-PC support). Requirements for personnel in excess of these 55 would be costed at 1.7 times direct salary for applications personnel and 1.5 times for communications. Beverly would be required to provide occupancy and environmentals for Systematics personnel located on Beverly's premises including computer terminals, etc. Systematics would pay severance for personnel hired from Beverly and terminated within 6 months. Beverly would be required to pay relocation expenses for personnel transferred to Fort Smith.

- *Hardware* - The base proposal provides for 35.5 MIPS of processor capacity (40.5 if the additional 5 is used for application development) and 180 gigabytes of DASD. CPU and DASD capacity can be either increased or decreased at a specified unit rate. Incremental rates are \$8780 per month for an additional 5 MIPS and \$3380 for an additional 10 gigabytes. Beverly will provide all non-mainframe hardware and software and pay communications costs.
- *Software* - Systematics would pay any costs associated with getting permission to run non-IBM software on Systematics facilities. However, Beverly would be required to retain the licenses and pay maintenance costs.

- *Financial* - Systematics initial proposal provided for inflation adjustments to be added each year based on the average of the ECI and CPI-U. The adjustment will apply to the base rate and the CPU and DASD incremental charges. In subsequent discussions between Beverly and Systematics, Systematics agreed to share the risk on inflation up to and including a 3% built into the base annual fee.
- *Service Levels* - Service levels are to be determined during the initial operating period, and Systematics commits to doing as well as the current operation. Disaster protection would be provided via a "cold site" agreement.

2. Observations and Comments

In general the proposal is comprehensive and logical. The ability to add or decrease resources at the same incremental rate is desirable and provides much flexibility. However, there are a number of areas which require further discussion and examination.

- The proposal does not address severance for employees terminated after 6 months. It is highly probable that it will take longer than 6 months to reduce the staff to a steady state level. If this, in fact, turns out to be the case, Beverly may wind up paying the bulk of the termination charges.
- Completion of the Forms and Pharmacy projects will require staff levels in excess of 49. In the original proposal these would have been charged at 1.7 times salary for the required duration. In subsequent discussions with Systematics, Systematics has agreed to retain the incremental development staff at its expense for a period of three months to complete the outstanding development projects. This concession will need to be documented in order to protect Beverly from potentially significant development charges.
- The proposed treatment of inflation appears reasonable at 3%. This would not be atypical of most outsourcing contracts. However, at the time of this writing, it was not clear to INPUT whether inflation charges beyond the 3% rate were to apply to hardware as well as personnel expense. Beverly should make every effort to exclude hardware from the inflation clause, items which consistently experience declining unit costs over time.
- The proposal does not specify the type of mainframe hardware on which Beverly is to run or the operating system release level. Given the commitment to capacity, Beverly can be assured of running on more advanced equipment than at present, but this should be specified.

- It is somewhat surprising that a "cold site" disaster protection arrangement is deemed adequate.

B. IBM/ISSC

IBM's response to Richard Wilcox's letter is contained in a letter dated April 24, 1992 from James P. Worley to William McBride, III, with modifications submitted in a letter from James Worley to Robert Woltil dated June 16, 1992. In INPUT's judgment the proposal is solid but reflects less in-depth knowledge of Beverly's business and interests than does the Systematics proposal.

1. Key Proposal Elements

- *Coverage* - IBM proposes assuming responsibility for application development and maintenance, data center operations (*including print operations and distribution*); training, voice and data communications management. In the original proposal, IBM proposed providing application development work at the current level. In the revised proposal, IBM indicates it will assume responsibility for completing all development work scheduled through 1992, providing enhancements through 1993, then continuing maintenance and enhancements at the ensuing rate for the remainder of the contract. This resulted in overall lower base charges than the original proposal.
- *Personnel* - IBM proposes hiring up to 111 Beverly employees; 93 application, 16 print distribution and 2 print operations. Beverly would have to pay other data center personnel during the transition period and presumably termination. Data center work would be relocated to a center in Lexington, Kentucky.
- *Hardware* - The base rate provides for 39.2 MIPS of CPU and 176 gigabytes of DASD. Work in excess of the base rate would result in Additional Resource Charges (ARC's). Processing would be on an ES/9000 (IBM's latest) and an ESA operating system.
- *Software* - IBM would pay maintenance or leases on 3rd party software, but Beverly would have to pay any fees associated with right to relocate the software from Beverly's to IBM's systems. (*The opposite of Systematics proposal.*)
- *Financial* - IBM commits to purchasing owned data center equipment at book value and assuming responsibilities for leases on leased equipment. The current proposal provides for inflation adjustments in excess of 3% of the CPI-U. In a telephone conversation held with ISSC's representative on July 8th it was confirmed that it was IBM's intent to have the same clause remain in their revised proposal. ISSC did indicate that it would be willing to negotiate a different clause, but didn't give any indications of what they might be willing to agree to.

The ARC's decrease through time for CPU and DASD but increase for tape mounts reflecting real economics.

- *Service Levels* - Service Level Agreements would be developed during contract negotiations based on historical performance. IBM also commits to upgrading the print technology in 1997. Disaster recover would be through IBM's Business Recovery Center ("hot-site").

2. Observations and Comments

IBM appears to have provided a complete proposal, and the recent modification that IBM submitted makes it more compatible with other options. The proposal has a number of positive points.

- IBM's commitment to technology is the best of the options. Quality of service should necessarily improve with the technology being offered.
- IBM's treatment of inflation is adequate as are the trends in its ARC's, though the magnitude of the ARCs looks high.
- The offer to take responsibility for existing equipment is attractive and is probably of economic benefit to Beverly.

However, there are a number of areas where IBM's lower base knowledge of Beverly's business raise some potential problems.

- While IBM's hiring proposal in aggregate should more than meet its needs, the persons it proposes hiring may not meet the necessary skill requirements. For instance, it failed to address communications support personnel, though it did commit to providing the service.
- Under IBM's proposal there is no provision for decreasing yearly charges in the event that Beverly's resource requirements should drop radically during the life of the contract. In other words, the charges will increase with growth but will not decrease with shrinkage.

Finally, in discussions with James Worley of IBM, it was learned that IBM's quote of 39.2 MIPS is an estimate and that the actual current running rate would be determined during the first 6 months of operation at IBM's facility. The base line would be established from this, and the estimated fee could be scaled up or down based on the current rate. Thereafter, increases in usage would result in additional resource charges (ARCs).

C. Base Case

1. Key Proposal Elements

The "Base Case", in-house, solution is documented in a letter of May 7, 1992 from Charles Chamberlain to Charles Mitchell with revisions in a letter dated June 3, 1992, and further detailed in a letter of June 10, 1992 to Bill McBride and Bob Woltil.

- *Coverage* - Coverage is comparable to that provided by the two outside proposals.
- *Personnel* - The personnel plan appears to be structured to match the services proposed by Systematics. It provides for 135 positions at present, reducing to 99 after completion of the Forms and Pharmacy projects in mid '93. The personnel plan excludes Distribution, the Help Desk and the Regional Consultants. Reduction is accomplished by dropping those positions currently charged to the Forms and Pharmacy Capital Projects (currently 18 positions each as reported in Chamberlain's document).
- *Hardware* - The proposal recommends replacing the existing 3084 CPU with a 3090/300E. This increases capacity to 45 MIPS and permits running the ESA operating system. The proposal further provides for replacing the 300E with a 9121/610 in 1996. This increases capacity to 71 MIPS, a very healthy increase. The proposal provides for increasing and replacing the DASD configuration over time from its existing 169 gigabytes of various 3380's to 227 gigabytes of 3390's. The proposal further provides for replacing the 3800 printer with a 3900 in 1995 and replacing the existing tape configuration with 3490's in 1995 after expanding the existing in 1993.
- *Software* - Software costs are documented in detail.
- *Financial* - Personnel costs are inflated at 5% per year. In addition to Wages/Related and Major Hardware/Software expenses, which are well documented, there is a category of Other expense declining from \$1.7 million in 1992 to \$1.1 million in 1998. This category was discussed with Charles Chamberlain. Most of these expenses should not have been included as they are expenses which Beverly would retain whether or not they outsource. Included were equipment costs for the Forms and Pharmacy Projects, End User and Programmer terminals and printers, computer stock, contractor wage, phones and travel.

One significant category of expense which was not included in the original in-house proposal was facilities. MIS is not charged for floor space, power or air conditioning. Removal of the Data Center should result in significant savings in this area. After several discussions an estimate of \$400K per year was agreed to for analysis purposes.

- *Service Levels* - The in-house proposal does not address service levels.

2. Observations and Comments

The equipment plan looks well thought out and should meet Beverly's needs at reasonable cost. Increasing to 71 MIPS looks out of line with the DASD growth and with the outsourcing proposals.

The personnel plan appears to provide consistency with the Systematics proposal in the aggregate. It provides for a larger "effective staff" than Systematics proposes but less than the number of people Systematics indicated would be required by Beverly to provide the same level of service they could provide. On the other hand, part of Systematics efficiency was due to improved response time which is provided by the proposed hardware.

The two real issues which make the in-house proposal most difficult to evaluate were not addressed directly in the proposal.

- Facilities expense including utilities still looks low. Furthermore, if Beverly wishes to relocate from Virginia Beach, facilities are a major consideration.
- The question of whether the in-house organization can really meet development commitments in a timely manner under the proposed staffing is extremely questionable, particularly in light of the organizations track record and the staff reductions outlined in the in-house proposal.

IV. Financial Analysis

A financial analysis of each proposal as it currently stands was prepared and is detailed in the spread sheet and accompanying notes in *Appendix A*.

An attempt was made to make the solutions as nearly identical as possible. Each alternative as developed provides for CPU and DASD as proposed; all software; a development staff which could meet maintenance, enhancement and minor development requirements; management of telecommunications; completion of the current Forms and Pharmacy projects; operation of the print/distribution facilities; terminals, occupancy and environmental costs for the resident staff; facilities for the data center; and comparable termination costs.

A. Base Case

- For the Base Case the major unknowns are the cost of facilities, "Other Costs", and the personnel termination charges. Facilities costs in the original analysis were estimated at \$250K per month. A revised estimate of \$400K per month was obtained from Ron Gill, and was used in this analysis.
- In Chamberlain's analysis, there is a category of expense labeled "Other". In discussing the nature of this expense with Charles Chamberlain, it was learned that it included \$426k for Forms and Pharmacy equipment, \$208k for forms, \$127k for travel, unknown number for contractors, etc. It is believed Beverly would retain most of this expense whether or not they outsource, so arbitrarily, \$1M was deducted. This obviously is not accurate, but it should be "in the ballpark" and representative.
- For personnel, a figure of three months pay was used for severance. This was discussed with Bill McBride, and if anything, the figure may be high.
- Costs for personnel to operate the print/distribution facility were added. Budget data was obtained from the Systematics Proposal but scaled down to 15 people from the 17.5 on which the budget was based. Costs for printer equipment and operation were included in Chamberlain's analysis as was all software. The big expense associated with continuing work in-house would be the relocation costs should Beverly decide to relocate the data center.
- Complement started at 135, reducing to 99 mid '93. The 99 people include: 6 in Software Services, 8 in Prod Control, 19 in Comp Operations, 1 in MIS Admin and 1 in Training & Doc (total 35) who support the Data Center and presumably would be displaced if outsourcing occurs. The remaining 64 include 7 in Communications, 44 coded Dept 86xx, 7 in NH Res Care (4 Cust Support and 3 Software Services), 4 in Corp MIS Ft Smith (2 Software Services, 2 MIS Admin), and 2 additional in Training & Doc (1 each in NH Billing/AR and PC Systems (FS)).

Whether this is the proper personnel mix is problematic, but the plan does include 21 persons coded Dept 86 who would be displaced when Forms and Pharmacy complete. Substitutions should be possible. The 64 people compare to 55 that Systematics proposes to staff. Systematics claims they can improve efficiency by 15 people, but 5 to 6 of these are due to main frame capacity increases which the base case provides. So the complements seem consistent in general.

B. Systematics

- The Systematics' Base Fee and Inflation charge are based on data in their proposals. A uniform inflation rate of 3% is assumed. This is consistent with the rate of increase used on salaries, hardware maintenance and software in the Base Case.
- The Systematics' proposal does not provide for print/distribution. The costs for equipment were taken directly from Chamberlain's memo at the rate they were included in the Base Case. Print/distribution personnel costs are identical to those added to the base case in the analysis as discussed above.
- Systematics requires Beverly to pay for non-IBM software. Costs were added to the Systematics case based on Chamberlain's data to make the basis consistent.
- In the original analysis costs were added to Systematics proposal for Development during the first year of the contract. In subsequent negotiations Systematics has agreed to pick up some significant portion of these charges. Therefore no development charges were included in this analysis.

C. IBM/ISSC

- The IBM proposal includes print/distribution costs and also includes all software except for charges associated with right to relocate.
- Inflation is assumed at 3% for purposes of this analysis. Where there are extra charges for the IBM service is in payroll and termination charges associated with the data center. The proposal provides that Beverly must continue to pay personnel until the work is relocated. Three months expense is included and three months salaries taken as severance.
- One half year 3rd part software expense is taken for relocation rights. This should be high.
- IBM will provide terminals and development equipment for its personnel whereas the Base Case and Systematics requires Beverly to provide terminals. A credit is given IBM based on 50 people at \$25 per month per terminal.
- IBM also offers to purchase owned data center equipment at book value and assume responsibility for leased equipment, while Systematics only offers to help Beverly in subleasing. This should be of financial benefit, but no credit was taken.

- The weakness of the IBM proposal is the lack of detail and the implication that much has to be developed during the contract negotiation and initial operating period. Their costs for data center services and level of development support are all subject to adjustment. More discussions would be required with IBM before a firm decision could be made.

D. Summary - Financial Analysis

Exhibit IV-1 compares the three proposals at the time of this writing. Costs are in millions over the seven year period. Base Costs represent the annual contract fees. The line labeled adjustments includes the sum of all adjustments made (as described above) to put each case on a comparable basis.

Exhibit IV-1
Comparison of Seven Year Outsourcing Costs
(Dollars in Millions)

	Base Case	Systematics	IBM/ISSC
Base Costs	56.4	57.3	59.5
Adjustments	-1.4	2.2	0.9
Total	55.0	59.5	60.4

Subsequent to adjustments the financial differences are not significant between the Systematics and IBM proposals. (This assumes that the verbal agreements reached on points discussed with the vendors between the original analysis of proposals and today will actually be incorporated into any further written proposals or contracts.) Furthermore, it's INPUT's belief that the in-house costs are still underestimated in the following areas:

- Facilities could be underestimated by as much as \$100,000 per year adding another \$700,000 to the cost of the Base Case.
- The ability to complete the outstanding develop under the proposed personnel plan could be significantly underestimated.

If this is the case the three proposals are financially comparable for all practical purposes. Some other considerations which need to be factored into the selection process are outlined below:

- An inconsistency seems to exist between Section 2.2 of Exhibit C in the Systematics' contract and the proposal. The proposal calls for Beverly to be responsible for the operation of the laser printers and Exhibit C imputes the responsibility to Systematics. If, in fact, Systematics means to include printer operations as part of the base contract than the "adjustments" number for Systematics should be lowered by some percentage of the \$4 million shown in the spread sheet in *Appendix A*.
- IBM's base fee is subject to some speculation. As previously mentioned, IBM's current proposal maintains the right to adjust the base fee (up or down) subject to initial contract experience. This doesn't fly. Minimally, this adjustment should be capped.
- The Base Case (in-house) numbers need to be re-examined. Despite INPUT's efforts to ascertain which portions of the "other costs" category should be eliminated from the Base Case to achieve comparability, Beverly itself should further fine tune these numbers.

Finally, two related points should be explored further before the financial comparison is finalized.

- The financial analysis is based on the assumption that proposed capacity will meet requirements throughout the contract period. There is somewhat of an inconsistency here as the Base Case provides extra capacity. If this capacity is needed it distorts the economics even more. IBM's incremental CPU capacity is much more granular than Systematics but is more expensive if significant increases are required. More information is needed on how IBM's CPU charges are figured. IBM's incremental cost for DASD is 50% greater than Systematics initially but is 25% less in year 7 (assuming 5% inflation), so if anything IBM might be less expensive. Systematics rate per gigabyte is \$338 increasing with inflation; IBM's is \$500 in year one decreasing to \$340 in year 7.
- Relocation of the data center from the personnel and print facilities will increase data network expenses. This fact was not factored in to the financials.

V. Non-Financial Considerations

Other than the financial differences there are few significant differences between the Systematics and IBM proposals.

- *Contract Termination* - Systematics does not permit contract termination in the first three years, IBM's fee is \$7.3M in years 2-4. Starting in year 4, Systematics termination fee is 25% of the remaining contract discounted at 4%. IBM's fee in subsequent years decreases from 7 to 5.8M. From years 5 on it would be less expensive to terminate Systematics contract but the difference is not great.

- *Account Management* - Both vendors proposals are comparable with respect to account management, relationship with a steering committee, capacity planning, service level agreements, billing, training, regulatory compliance, day-to-day administration, and security.
- *Disaster Recovery* - Disaster Recovery is provided by "hot site" by IBM and "Cold Site" by Systematics. These items need to be hammered out in the contract, but they are relatively standard.
- *Relocation* - Beverly has a desire to relocate operations from Virginia Beach. Neither Systematics nor IBM have included expenses to relocate personnel. Systematics say it would be at Beverly's expense. IBM has not addressed the subject only hoping that it would occur before hiring personnel. Both vendors have plans to operate the data center remote from Virginia Beach, greatly simplifying the relocation.

VI. Contract Considerations

At the time of first analysis Systematics had submitted a draft contract to Beverly Enterprises. INPUT reviewed the proposed contract and made several observations. Unless Systematics has submitted revisions to that contract between the preliminary analysis dated, June 28th and now, INPUT believes the following points need to be addressed.

- *Technical Content* - The technical content of the proposed contract appears to be weak. The following kinds of questions probably need to be resolved.
 - What hardware Beverly will run on and what operating system release? Will the environment be dedicated?
 - How Beverly can be assured of remaining current with respect to technology or operating system release levels?
 - What technology will be used for running the laser printers remotely and how will terminals will be configured?
 - Will Beverly be required to change standards, naming conventions, JCL, etc.? Will the end user interface change?
 - What notification will Systematics give before making changes in the system? Will Beverly have the opportunity to approve?

- What will be the nature of Systematics' Stewardship reporting on capacity utilization, reliability, response time, etc.?
- What is Systematics schedule for backing up DASD? What is the process for restoration, does Systematics automatically archive?
- Will any changes be required in Tape Management procedures.

These items do not all need to be covered by the contract, but if not, they should be in an "Operations Manual" identified in the contract which should be developed shortly after transfer of responsibilities.

- *Service Level Agreements* - Ron Gill has make a good start on the Service Level Agreement. Certainly, Beverly should not accept less quality than they currently get. Schedules of system availability should be a must. Reliability/availability objectives should be established and measured as a function of scheduled up time. Beverly should consider objectives which address both the frequency of failures as well as the total time of downtime. Numerous small outages may be more objectionable than a few longer ones. Schedules for production work should be defined. Procedures should be established for changing schedules. Here again an operations manual approach may be desirable. This can be more easily changed than the contract.
- *Audit* - Beverly should have the right to validate/audit its use of resources. Giving the vendor freedom to determine equity of capacity during changes of CPU's or operating systems is inappropriate. They should be required to justify using readily available references or benchmarks.
- *Personnel* - In the personnel area, the vendor should commit to parity of salary plus benefits. What about any scheduled merits? What about guaranteed employment or right to severance? Commitment to 6 months seems short.
- *Mediation/Arbitration* - In the areas of dispute mediation, liability, termination, bankruptcy, indemnification, etc., a capable attorney should be used. In case of termination due to default of the vendor, the vendor should be required to pay clients costs for relocation. The whole Systematics draft looks a bit one-sided. Much more protection to the vendor than client. It should be balanced.
- *Other* - The apparent inconsistency pointed out earlier between Systematics' proposal and Section 2.2 of Exhibit C needs to be resolved. The proposal calls for Beverly to be responsible for and operate the laser printers. Exhibit C implies this responsibility to Systematics.

These are cursory comments with regard to the Systematics proposed contract. Undoubtedly a comparable list would need to be developed for any proposed IBM agreement. However, a more thorough analysis would entail a revision of the scope of work agreed to for this study.

VII. Conclusions and Recommendations

A. Conclusions

- *Playing Field* - INPUT believes that the processes utilized by Beverly to date have given all parties a fair opportunity to bid. Although it is clear that Beverly is more comfortable with Systematics as a potential partner, INPUT has uncovered no evidence which would indicate that ISSC has been deliberately placed at a disadvantage in the process.
- *Internal IS Function* - There exists a high level of dissatisfaction with the internal systems function; at least among those individuals at Beverly with whom INPUT had an opportunity to interface during the study. The dissatisfaction is particularly high with regard to development activities. While this in itself is not a sufficient reason to outsource, it pushes the decision in that direction. An alternative approach would be to re-engineer the internal IS function including management, organization and processes to upgrade the activity. However, the time consumed particularly in the light of Beverly's stated short term requirements, and the desire to relocate probably makes the re-engineering the least attractive alternative.
- *Existing Vendor Proposals* - Assuming that the proposal changes, agreed to verbally between Systematics and Beverly, will be documented in writing, the ISSC and the Systematics proposals are financially comparable. As detailed in previous sections, each has relative areas of strength over the other. IBM's commitment to the completion of existing development activity is cleaner than Systematics. And INPUT believes that IBM would provide a superior technology platform. On the other hand, Systematics proposal demonstrates a more in-depth understanding of Beverly's business and leaves considerably less to be debated during contract negotiations than does ISSC's.

B. Recommendations

Based on the analysis done to date INPUT recommends that Beverly make one last pass at IBM to see if some of the vague aspects of the proposal can be cleared up. Unless this yields some reasonably dramatic change in the nature of the proposal, INPUT would recommend that Beverly proceed with contract negotiations with Systematics using the following approach:

- Systematics should be required to either re-bid the proposal or resubmit the proposed contract reflecting in writing the changes in clauses regarding inflation, completion of current development, etc., that have been negotiated verbally over the last week.
- A team should be set up to develop the "Operations Manual" discussed earlier, and efforts made to insure that the weaker technical aspects of the Systematics proposal can be resolved and documented for the life of the contract.
- Beverly should consider continued use of INPUT or select another firm with actual experience in contract negotiations throughout the contract development. This is particularly important given the status of the existing internal information systems function. Obviously, outside legal advisors (as already engaged) will be required.

Above all, negotiations should not be rushed, and documenting all assumptions as they occur during the course of the negotiations will provide a handy checklist to insure that key contract elements are not left out of the deal by simple oversight.

APPENDIX A:

Financial Analysis

Outsourcing Contract Analysis

Beverly Enterprises, INC.

FINANCIAL ANALYSIS OF BEVERLY ENTERPRISE ALTERNATIVES

(Costs in thousands; one half year in 1992 and 1999)

BASE CASE

YEAR	1992	1993	1994	1995	1996	1997	1998	1999	TOTAL	N
Quoted \$	4492	8083	7398	7617	7867	8139	8416	4342	56354	1
Less Other	-500	-1000	-1000	-1000	-1000	-1000	-1000	-500	-7000	2
Print Pers	154	323	339	356	374	393	412	216	2567	3
Facilities	200	400	400	400	400	400	400	200	2800	4
Termn	0	278							278	5
Effec Cost	4346	8084	7137	7373	7641	7932	8228	4258	54999	
Total	\$55.0 Million									
MIPS	45	45	45	45	71	71	71	71		
DASD	169	169	184	220	220	227	227	227		

SYSTEMATICS PROPOSAL

Base Fee	4835	8810	7950	7950	7950	7950	7950	3975	57370	6
Staff Adj.	-340	-680	-680	-680	-680	-680	-680	-340	-4760	7
Print Chgs	137	183	191	207	214	220	227	117	1496	8
Print Pers	154	323	339	356	374	393	412	216	2567	9
Software	348	348	348	348	348	348	348	348	2784	10
Effec Cost	5134	8984	8148	8181	8206	8231	8257	4316	59457	
Total	\$59.5 Million									
MIPS	35/41	35/41	35/41	35/41	35/41	35/41	35/41	35/41		
DASD	180	180	180	180	180	180	180	180		

IBM PROPOSAL

Base Fee	4250	8500	8500	8500	8500	8500	8500	4250	59500	11
Termn	344								344	12
Temp Pers	443								443	13
Software	174								174	14
Term Crdt	-8	-15	-15	-15	-15	-15	-15	-7	-105	15
Effec Cost	5203	8485	8485	8485	8485	8485	8485	4243	60356	
Total	\$60.4 Million									
MIPS	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2		
DASD	176	176	176	176	176	176	176	176		

NOTES TO THE FINANCIAL ANALYSIS

1. Totals from Charles Chamberlain letter of June 3. One half year in '92 and '99.
2. Arbitrarily reduced "Other Expense" by \$1m per year. Most of these are not included in other proposals.
3. IBM included all costs associated with printing. Chamberlain's costs included print facilities but not personnel. Add Distribution personnel costs based on budget pro rated for 15 persons instead of 17.5. Inflated 5% per year.
4. Occupancy and environmental costs based on Systematics analysis. Revised estimates provided by Ron Gill in early July. Cost for raised floor still looks low.
5. Termination costs are for 36 people, arbitrarily 3 months salary. The personnel included are those allocated to Forms and Pharmacy projects. Their salaries were removed from Chamberlain's projection mid '93.
6. Base fees are as tabulated in Systematics Amendment to Proposal dated April 13,, 1992. 1992 has one half of year one rate, 1993 has half year of year one and half year of year two, etc.
7. Reduction in staff in Systematics proposal to achieve comparability with the in-house proposal.
8. Printer costs are as tabulated in Charles Chamberlain letter of May 7, 1992. Systematics excluded print and distribution costs but others included it.
9. Personnel costs for print an distribution added per Chamberlain's estimates.
10. Systematics proposal provides for Beverly to pay license and maintenance fees for non-IBM software. Cost for software is documented in Charlie Chamberlain's letter of May 7. Software costs were kept constant as suggested by the letter.
11. IBM's letter of June 16,1992 quoted a rate of \$59.5M for seven years; set as 8.5/year.
12. IBM's proposal provides that Beverly must pay personnel costs to operate the center till work is moved to Lexington. Wage related expense for the 52 people not hired by IBM or kept by Beverly are assumed to be required for 3 months.

13. Beverly must pay the termination costs for the people let go that are not hired by IBM. Three months salaries are taken as severance for the same people as Note 12.
14. IBM's proposal requires Beverly to pay any costs associated with getting rights to use 3rd party software. This is an off-the-wall guess that charges would equal half a year of maintenance. This is probably quite high as D&B is one third of the cost and they should not charge.
15. IBM plans to provide its development personnel with PS2's and productivity tools. Credit is taken for terminals for 50 people at \$25 per month. Not a large figure, but Systematics requires Beverly to provide terminals and of course the in-house solution would as well.

About INPUT

INPUT is a worldwide consulting and market research firm uniquely focused on the information technology services and software markets. Executives in many technically advanced companies in North America, Europe, and Japan rely on INPUT for data, objective analysis, and insightful opinions to support their business plans, market assessments, and technology directions. By leveraging INPUT's considerable knowledge and expertise, clients make informed decisions more quickly, and benefit by saving on the cost of internal research.

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